

(f) *Coordination with intangible property rules.* The value of an item of tangible property may be affected by the value of intangible property, such as a trademark affixed to the tangible property (embedded intangible). Ordinarily, the transfer of tangible property with an embedded intangible will not be considered a transfer of such intangible if the controlled purchaser does not acquire any rights to exploit the intangible property other than rights relating to the resale of the tangible property under normal commercial practices. Pursuant to § 1.482-1(d)(3)(v), however, the embedded intangible must be accounted for in evaluating the comparability of the controlled transaction and uncontrolled comparables. For example, because product comparability has the greatest effect on an application of the comparable uncontrolled price method, trademarked tangible property may be insufficiently comparable to unbranded tangible property to permit a reliable application of the comparable uncontrolled price method. The effect of embedded intangibles on comparability will be determined under the principles of § 1.482-4. If the transfer of tangible property conveys to the recipient a right to exploit an embedded intangible (other than in connection with the resale of that item of tangible property), it may be necessary to determine the arm's length consideration for such intangible separately from the tangible property, applying methods appropriate to determining the arm's length result for a transfer of intangible property under § 1.482-4. For example, if the transfer of a machine conveys the right to exploit a manufacturing process incorporated in the machine, then the arm's length consideration for the transfer of that right must be determined separately under § 1.482-4.

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§ 1.482-4 Methods to determine taxable income in connection with a transfer of intangible property.

(a) *In general.* The arm's length amount charged in a controlled transfer of intangible property must be determined under one of the four meth-

ods listed in this paragraph (a). Each of the methods must be applied in accordance with all of the provisions of § 1.482-1, including the best method rule of § 1.482-1(c), the comparability analysis of § 1.482-1(d), and the arm's length consideration for the transfer of an intangible determined under this section must be commensurate with the income attributable to the intangible. See § 1.482-4(f)(2) (Periodic adjustments). The available methods are—

(1) The comparable uncontrolled transaction method, described in paragraph (c) of this section;

(2) The comparable profits method, described in § 1.482-5;

(3) The profit split method, described in § 1.482-6; and

(4) Unspecified methods described in paragraph (d) of this section.

(b) *Definition of intangible.* For purposes of section 482, an intangible is an asset that comprises any of the following items and has substantial value independent of the services of any individual—

(1) Patents, inventions, formulae, processes, designs, patterns, or know-how;

(2) Copyrights and literary, musical, or artistic compositions;

(3) Trademarks, trade names, or brand names;

(4) Franchises, licenses, or contracts;

(5) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and

(6) Other similar items. For purposes of section 482, an item is considered similar to those listed in paragraph (b)(1) through (5) of this section if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.

(c) *Comparable uncontrolled transaction method—*(1) *In general.* The comparable uncontrolled transaction method evaluates whether the amount charged for a controlled transfer of intangible property was arm's length by reference to the amount charged in a comparable uncontrolled transaction. The amount determined under this method may be adjusted as required by paragraph (f)(2) of this section (Periodic adjustments).

(2) *Comparability and reliability considerations*—(i) *In general*. Whether results derived from applications of this method are the most reliable measure of an arm's length result is determined using the factors described under the best method rule in § 1.482-1(c). The application of these factors under the comparable uncontrolled transaction method is discussed in paragraphs (c)(2)(ii), (iii), and (iv) of this section.

(ii) *Reliability*. If an uncontrolled transaction involves the transfer of the same intangible under the same, or substantially the same, circumstances as the controlled transaction, the results derived from applying the comparable uncontrolled transaction method will generally be the most direct and reliable measure of the arm's length result for the controlled transfer of an intangible. Circumstances between the controlled and uncontrolled transactions will be considered substantially the same if there are at most only minor differences that have a definite and reasonably ascertainable effect on the amount charged and for which appropriate adjustments are made. If such uncontrolled transactions cannot be identified, uncontrolled transactions that involve the transfer of comparable intangibles under comparable circumstances may be used to apply this method, but the reliability of the analysis will be reduced.

(iii) *Comparability*—(A) *In general*. The degree of comparability between controlled and uncontrolled transactions is determined by applying the comparability provisions of § 1.482-1(d). Although all of the factors described in § 1.482-1(d)(3) must be considered, specific factors may be particularly relevant to this method. In particular, the application of this method requires that the controlled and uncontrolled transactions involve either the same intangible property or comparable intangible property, as defined in paragraph (c)(2)(iii)(B)(1) of this section. In addition, because differences in contractual terms, or the economic conditions in which transactions take place, could materially affect the amount charged, comparability under this method also depends on similarity with respect to these factors, or adjust-

ments to account for material differences in such circumstances.

(B) *Factors to be considered in determining comparability*—(1) *Comparable intangible property*. In order for the intangible property involved in an uncontrolled transaction to be considered comparable to the intangible property involved in the controlled transaction, both intangibles must—

(i) Be used in connection with similar products or processes within the same general industry or market; and

(ii) Have similar profit potential. The profit potential of an intangible is most reliably measured by directly calculating the net present value of the benefits to be realized (based on prospective profits to be realized or costs to be saved) through the use or subsequent transfer of the intangible, considering the capital investment and start-up expenses required, the risks to be assumed, and other relevant considerations. The need to reliably measure profit potential increases in relation to both the total amount of potential profits and the potential rate of return on investment necessary to exploit the intangible. If the information necessary to directly calculate net present value of the benefits to be realized is unavailable, and the need to reliably measure profit potential is reduced because the potential profits are relatively small in terms of total amount and rate of return, comparison of profit potential may be based upon the factors referred to in paragraph (c)(2)(iii)(B)(2) of this section. See *Example 3* of § 1.482-4(c)(4). Finally, the reliability of a measure of profit potential is affected by the extent to which the profit attributable to the intangible can be isolated from the profit attributable to other factors, such as functions performed and other resources employed.

(2) *Comparable circumstances*. In evaluating the comparability of the circumstances of the controlled and uncontrolled transactions, although all of the factors described in § 1.482-1(d)(3) must be considered, specific factors that may be particularly relevant to this method include the following—

(i) The terms of the transfer, including the exploitation rights granted in

the intangible, the exclusive or non-exclusive character of any rights granted, any restrictions on use, or any limitations on the geographic area in which the rights may be exploited;

(ii) The stage of development of the intangible (including, where appropriate, necessary governmental approvals, authorizations, or licenses) in the market in which the intangible is to be used;

(iii) Rights to receive updates, revisions, or modifications of the intangible;

(iv) The uniqueness of the property and the period for which it remains unique, including the degree and duration of protection afforded to the property under the laws of the relevant countries;

(v) The duration of the license, contract, or other agreement, and any termination or renegotiation rights;

(vi) Any economic and product liability risks to be assumed by the transferee;

(vii) The existence and extent of any collateral transactions or ongoing business relationships between the transferee and transferor; and

(viii) The functions to be performed by the transferor and transferee, including any ancillary or subsidiary services.

(iv) *Data and assumptions.* The reliability of the results derived from the comparable uncontrolled transaction method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply this method. See § 1.482-1(c) (Best method rule).

(3) *Arm's length range.* See § 1.482-1(e)(2) for the determination of an arm's length range.

(4) *Examples.* The following examples illustrate the principles of this paragraph (c).

Example 1. (i) USpharm, a U.S. pharmaceutical company, develops a new drug Z that is a safe and effective treatment for the disease zeezee. USpharm has obtained patents covering drug Z in the United States and in various foreign countries. USpharm has also obtained the regulatory authorizations necessary to market drug Z in the United States and in foreign countries.

(ii) USpharm licenses its subsidiary in country X, Xpharm, to produce and sell drug Z in country X. At the same time, it licenses

an unrelated company, Ydrug, to produce and sell drug Z in country Y, a neighboring country. Prior to licensing the drug, USpharm had obtained patent protection and regulatory approvals in both countries and both countries provide similar protection for intellectual property rights. Country X and country Y are similar countries in terms of population, per capita income and the incidence of disease zeezee. Consequently, drug Z is expected to sell in similar quantities and at similar prices in both countries. In addition, costs of producing and marketing drug Z in each country are expected to be approximately the same.

(iii) USpharm and Xpharm establish terms for the license of drug Z that are identical in every material respect, including royalty rate, to the terms established between USpharm and Ydrug. In this case the district director determines that the royalty rate established in the Ydrug license agreement is a reliable measure of the arm's length royalty rate for the Xpharm license agreement.

Example 2. The facts are the same as in *Example 1*, except that the incidence of the disease zeezee in Country Y is much higher than in Country X. In this case, the profit potential from exploitation of the right to make and sell drug Z is likely to be much higher in country Y than it is in Country X. Consequently, the Ydrug license agreement is unlikely to provide a reliable measure of the arm's length royalty rate for the Xpharm license.

Example 3. (i) FP, is a foreign company that designs, manufactures and sells industrial equipment. FP has developed proprietary components that are incorporated in its products. These components are important in the operation of FP's equipment and some of them have distinctive features, but other companies produce similar components and none of these components by itself accounts for a substantial part of the value of FP's products.

(ii) FP licenses its U.S. subsidiary, USSub, exclusive North American rights to use the patented technology for producing component X, a heat exchanger used for cooling operating mechanisms in industrial equipment. Component X incorporates proven technology that makes it somewhat more efficient than the heat exchangers commonly used in industrial equipment. FP also agrees to provide technical support to help adapt component X to USSub's products and to assist with initial production. Under the terms of the license agreement USSub pays FP a royalty equal to 3 percent of sales of USSub equipment incorporating component X.

(iii) FP does not license unrelated parties to use component X, but many similar components are transferred between uncontrolled taxpayers. Consequently, the district director decides to apply the comparable uncontrolled transaction method to evaluate

whether the 3 percent royalty for component X is an arm's length royalty.

(iv) The district director uses a database of company documents filed with the Securities and Exchange Commission (SEC) to identify potentially comparable license agreements between uncontrolled taxpayers that are on file with the SEC. The district director identifies 40 license agreements that were entered into in the same year as the controlled transfer or in the prior or following year, and that relate to transfers of technology associated with industrial equipment that has similar applications to USSub's products. Further review of these uncontrolled agreements indicates that 25 of them involved components that have a similar level of technical sophistication as component X and could be expected to play a similar role in contributing to the total value of the final product.

(v) The district director makes a detailed review of the terms of each of the 25 uncontrolled agreements and finds that 15 of them are similar to the controlled agreement in that they all involve—

(A) The transfer of exclusive rights for the North American market;

(B) Products for which the market could be expected to be of a similar size to the market for the products into which USSub incorporates component X;

(C) The transfer of patented technology;

(D) Continuing technical support;

(E) Access to technical improvements;

(F) Technology of a similar age; and

(G) A similar duration of the agreement.

(vi) Based on these factors and the fact that none of the components to which these license agreements relate accounts for a substantial part of the value of the final products, the district director concludes that these fifteen intangibles have similar profit potential to the component X technology.

(vii) The 15 uncontrolled comparables produce the following royalty rates:

| License | Royalty rate (percent) |
|----------|------------------------|
| 1 | 1.0 |
| 2 | 1.0 |
| 3 | 1.25 |
| 4 | 1.25 |
| 5 | 1.5 |
| 6 | 1.5 |
| 7 | 1.75 |
| 8 | 2.0 |
| 9 | 2.0 |
| 10 | 2.0 |
| 11 | 2.25 |
| 12 | 2.5 |
| 13 | 2.5 |
| 14 | 2.75 |
| 15 | 3.0 |

(viii) Although the uncontrolled comparables are clearly similar to the controlled transaction, it is likely that uniden-

tified material differences exist between the uncontrolled comparables and the controlled transaction. Therefore, an appropriate statistical technique must be used to establish the arm's length range. In this case the district director uses the interquartile range to determine the arm's length range. Therefore, the arm's length range covers royalty rates from 1.25 to 2.5 percent, and an adjustment is warranted to the 3 percent royalty charged in the controlled transfer. The district director determines that the appropriate adjustment corresponds to a reduction in the royalty rate to 2.0 percent, which is the median of the uncontrolled comparables.

Example 4. (i) USdrug, a U.S. pharmaceutical company, has developed a new drug, Nosplit, that is useful in treating migraine headaches and produces no significant side effects. Nosplit replaces another drug, Lessplit, that USdrug had previously produced and marketed as a treatment for migraine headaches. A number of other drugs for treating migraine headaches are already on the market, but Nosplit can be expected rapidly to dominate the worldwide market for such treatments and to command a premium price since all other treatments produce side effects. Thus, USdrug projects that extraordinary profits will be derived from Nosplit in the U.S. market and other markets.

(ii) USdrug licenses its newly established European subsidiary, Eurodrug, the rights to produce and market Nosplit in the European market. In setting the royalty rate for this license, USdrug considers the royalty that it established previously when it licensed the right to produce and market Lessplit in the European market to an unrelated European pharmaceutical company. In many respects the two license agreements are closely comparable. The drugs were licensed at the same stage in their development and the agreements conveyed identical rights to the licensees. Moreover, there appear to have been no significant changes in the European market for migraine headache treatments since Lessplit was licensed. However, at the time that Lessplit was licensed there were several other similar drugs already on the market to which Lessplit was not in all cases superior. Consequently, the projected and actual Lessplit profits were substantially less than the projected Nosplit profits. Thus, USdrug concludes that the profit potential of Lessplit is not similar to the profit potential of Nosplit, and the Lessplit license agreement consequently is not a comparable uncontrolled transaction for purposes of this paragraph (c) in spite of the other indicia of comparability between the two intangibles.

(d) *Unspecified methods*—(1) *In general.* Methods not specified in paragraphs (a)(1), (2), and (3) of this section may be used to evaluate whether the amount

charged in a controlled transaction is arm's length. Any method used under this paragraph (d) must be applied in accordance with the provisions of § 1.482-1. Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it. For example, the comparable uncontrolled transaction method compares a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price the parties would have agreed to had they resorted directly to a market alternative to the controlled transaction. Therefore, in establishing whether a controlled transaction achieved an arm's length result, an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction. As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm's length result under the principles of the best method rule. See § 1.482-1(c). Therefore, in accordance with § 1.482-1(d) (Comparability), to the extent that a method relies on internal data rather than uncontrolled comparables, its reliability will be reduced. Similarly, the reliability of a method will be affected by the reliability of the data and assumptions used to apply the method, including any projections used.

(2) *Example.* The following example illustrates an application of the principle of this paragraph (d).

Example. (i) USbond is a U.S. company that licenses to its foreign subsidiary, Eurobond, a proprietary process that permits the manufacture of Longbond, a long-lasting industrial adhesive, at a substantially lower cost than otherwise would be possible. Using the proprietary process, Eurobond manufactures Longbond and sells it to related and unrelated parties for the market price of \$550 per ton. Under the terms of the license agreement, Eurobond pays USbond a royalty of \$100 per ton of Longbond sold. USbond also manufactures and markets Longbond in the United States.

(ii) In evaluating whether the consideration paid for the transfer of the proprietary process to Eurobond was arm's length, the district director may consider, subject to the best method rule of § 1.482-1(c), USbond's alternative of producing and selling Longbond itself. Reasonably reliable estimates indicate that if USbond directly supplied Longbond to the European market, a selling price of \$300 per ton would cover its costs and provide a reasonable profit for its functions, risks and investment of capital associated with the production of Longbond for the European market. Given that the market price of Longbond was \$550 per ton, by licensing the proprietary process to Eurobond, USbond forgoes \$250 per ton of profit over the profit that would be necessary to compensate it for the functions, risks and investment involved in supplying Longbond to the European market itself. Based on these facts, the district director concludes that a royalty of \$100 for the proprietary process is not arm's length.

(e) *Coordination with tangible property rules.* See § 1.482-3(f) for the provisions regarding the coordination between the tangible property and intangible property rules.

(f) *Special rules for transfers of intangible property*—(1) *Form of consideration.* If a transferee of an intangible pays nominal or no consideration and the transferor has retained a substantial interest in the property, the arm's length consideration shall be in the form of a royalty, unless a different form is demonstrably more appropriate.

(2) *Periodic adjustments*—(i) *General rule.* If an intangible is transferred under an arrangement that covers more than one year, the consideration charged in each taxable year may be adjusted to ensure that it is commensurate with the income attributable to the intangible. Adjustments made pursuant to this paragraph (f)(2) shall be consistent with the arm's length standard and the provisions of § 1.482-1. In determining whether to make such adjustments in the taxable year under examination, the district director may consider all relevant facts and circumstances throughout the period the intangible is used. The determination in an earlier year that the amount charged for an intangible was an arm's length amount will not preclude the district director in a subsequent taxable year from making an adjustment

to the amount charged for the intangible in the subsequent year. A periodic adjustment under the commensurate with income requirement of section 482 may be made in a subsequent taxable year without regard to whether the taxable year of the original transfer remains open for statute of limitation purposes. For exceptions to this rule see paragraph (f)(2)(ii) of this section.

(ii) *Exceptions*—(A) *Transactions involving the same intangible*. If the same intangible was transferred to an uncontrolled taxpayer under substantially the same circumstances as those of the controlled transaction; this transaction serves as the basis for the application of the comparable uncontrolled transaction method in the first taxable year in which substantial periodic consideration was required to be paid; and the amount paid in that year was an arm's length amount, then no allocation in a subsequent year will be made under paragraph (f)(2)(i) of this paragraph for a controlled transfer of intangible property.

(B) *Transactions involving comparable intangible*. If the arm's length result is derived from the application of the comparable uncontrolled transaction method based on the transfer of a comparable intangible under comparable circumstances to those of the controlled transaction, no allocation will be made under paragraph (f)(2)(i) of this section if each of the following facts is established—

(1) The controlled taxpayers entered into a written agreement (controlled agreement) that provided for an amount of consideration with respect to each taxable year subject to such agreement, such consideration was an arm's length amount for the first taxable year in which substantial periodic consideration was required to be paid under the agreement, and such agreement remained in effect for the taxable year under review;

(2) There is a written agreement setting forth the terms of the comparable uncontrolled transaction relied upon to establish the arm's length consideration (uncontrolled agreement), which contains no provisions that would permit any change to the amount of consideration, a renegotiation, or a termination of the agreement, in cir-

cumstances comparable to those of the controlled transaction in the taxable year under review (or that contains provisions permitting only specified, non-contingent, periodic changes to the amount of consideration);

(3) The controlled agreement is substantially similar to the uncontrolled agreement, with respect to the time period for which it is effective and the provisions described in paragraph (f)(2)(ii)(B)(2) of this section;

(4) The controlled agreement limits use of the intangible to a specified field or purpose in a manner that is consistent with industry practice and any such limitation in the uncontrolled agreement;

(5) There were no substantial changes in the functions performed by the controlled transferee after the controlled agreement was executed, except changes required by events that were not foreseeable; and

(6) The aggregate profits actually earned or the aggregate cost savings actually realized by the controlled taxpayer from the exploitation of the intangible in the year under examination, and all past years, are not less than 80% nor more than 120% of the prospective profits or cost savings that were foreseeable when the comparability of the uncontrolled agreement was established under paragraph (c)(2) of this section.

(C) *Methods other than comparable uncontrolled transaction*. If the arm's length amount was determined under any method other than the comparable uncontrolled transaction method, no allocation will be made under paragraph (f)(2)(i) of this section if each of the following facts is established—

(1) The controlled taxpayers entered into a written agreement (controlled agreement) that provided for an amount of consideration with respect to each taxable year subject to such agreement, and such agreement remained in effect for the taxable year under review;

(2) The consideration called for in the controlled agreement was an arm's length amount for the first taxable year in which substantial periodic consideration was required to be paid, and relevant supporting documentation was prepared contemporaneously with

the execution of the controlled agreement;

(3) There have been no substantial changes in the functions performed by the transferee since the controlled agreement was executed, except changes required by events that were not foreseeable; and

(4) The total profits actually earned or the total cost savings realized by the controlled transferee from the exploitation of the intangible in the year under examination, and all past years, are not less than 80% nor more than 120% of the prospective profits or cost savings that were foreseeable when the controlled agreement was entered into.

(D) *Extraordinary events.* No allocation will be made under paragraph (f)(2)(i) of this section if the following requirements are met—

(1) Due to extraordinary events that were beyond the control of the controlled taxpayers and that could not reasonably have been anticipated at the time the controlled agreement was entered into, the aggregate actual profits or aggregate cost savings realized by the taxpayer are less than 80% or more than 120% of the prospective profits or cost savings; and

(2) All of the requirements of paragraph (f)(2)(ii) (B) or (C) of this section are otherwise satisfied.

(E) *Five-year period.* If the requirements of § 1.482-4 (f)(2)(ii)(B) or (f)(2)(ii)(C) are met for each year of the five-year period beginning with the first year in which substantial periodic consideration was required to be paid, then no periodic adjustment will be made under paragraph (f)(2)(i) of this section in any subsequent year.

(iii) *Examples.* The following examples illustrate this paragraph (f)(2).

Example 1. (i) USdrug, a U.S. pharmaceutical company, has developed a new drug, Nosplit, that is useful in treating migraine headaches and produces no significant side effects. A number of other drugs for treating migraine headaches are already on the market, but Nosplit can be expected rapidly to dominate the worldwide market for such treatments and to command a premium price since all other treatments produce side effects. Thus, USdrug projects that extraordinary profits will be derived from Nosplit in the U.S. and European markets.

(ii) USdrug licenses its newly established European subsidiary, Eurodrug, the rights to

produce and market Nosplit for the European market for 5 years. In setting the royalty rate for this license, USdrug makes projections of the annual sales revenue and the annual profits to be derived from the exploitation of Nosplit by Eurodrug. Based on the projections, a royalty rate of 3.9% is established for the term of the license.

(iii) In Year 1, USdrug evaluates the royalty rate it received from Eurodrug. Given the high profit potential of Nosplit, USdrug is unable to locate any uncontrolled transactions dealing with licenses of comparable intangible property. USdrug therefore determines that the comparable uncontrolled transaction method will not provide a reliable measure of an arm's length royalty. However, applying the comparable profits method to Eurodrug, USdrug determines that a royalty rate of 3.9% will result in Eurodrug earning an arm's length return for its manufacturing and marketing functions.

(iv) In Year 5, the U.S. income tax return for USdrug is examined, and the district director must determine whether the royalty rate between USdrug and Eurodrug is commensurate with the income attributable to Nosplit. In making this determination, the district director considers whether any of the exceptions in § 1.482-4(f)(2)(ii) are applicable. In particular, the district director compares the profit projections attributable to Nosplit made by USdrug against the actual profits realized by Eurodrug. The projected and actual profits are as follows:

| | Profit projections | Actual profits |
|--------------|--------------------|----------------|
| Year 1 | 200 | 250 |
| Year 2 | 250 | 300 |
| Year 3 | 500 | 600 |
| Year 4 | 350 | 200 |
| Year 5 | 100 | 100 |
| Total | 1400 | 1450 |

(v) The total profits earned through Year 5 were not less than 80% nor more than 120% of the profits that were projected when the license was entered into. If the district director determines that the other requirements of § 1.482-4(f)(2)(ii)(C) were met, no adjustment will be made to the royalty rate between USdrug and Eurodrug for the license of Nosplit.

Example 2. (i) The facts are the same as in *Example 1*, except that Eurodrug's actual profits earned were much higher than the projected profits, as follows:

| | Profit projections | Actual profits |
|--------------|--------------------|----------------|
| Year 1 | 200 | 250 |
| Year 2 | 250 | 500 |
| Year 3 | 500 | 800 |
| Year 4 | 350 | 700 |
| Year 5 | 100 | 600 |

| | Profit projections | Actual profits |
|-------------|-----------------------|----------------|
| Total | 1400 | 2850 |

(ii) In examining USdrug's tax return for Year 5, the district director considers the actual profits realized by Eurodrug in Year 5, and all past years. Accordingly, although Years 1 through 4 may be closed under the statute of limitations, for purposes of determining whether an adjustment should be made with respect to the royalty rate in Year 5 with respect to Nosplit, the district director aggregates the actual profits from those years with the profits of Year 5. However, the district director will make an adjustment, if any, only with respect to Year 5.

Example 3. (i) FP, a foreign corporation, licenses to USS, its U.S. subsidiary, a new air-filtering process that permits manufacturing plants to meet new environmental standards. The license runs for a 10-year period, and the profit derived from the new process is projected to be \$15 million per year, for an aggregate profit of \$150 million.

(ii) The royalty rate for the license is based on a comparable uncontrolled transaction involving a comparable intangible under comparable circumstances. The requirements of paragraphs (f)(2)(ii)(B)(1) through (5) of this section have been met. Specifically, FP and USS have entered into a written agreement that provides for a royalty in each year of the license, the royalty rate is considered arm's length for the first taxable year in which a substantial royalty was required to be paid, the license limited the use of the process to a specified field, consistent with industry practice, and there are no substantial changes in the functions performed by USS after the license was entered into.

(iii) In examining Year 4 of the license, the district director determines that the aggregate actual profits earned by USS through Year 4 are \$30 million, less than 80% of the projected profits of \$60 million. However, USS establishes to the satisfaction of the district director that the aggregate actual profits from the process are less than 80% of the projected profits in Year 3 because an earthquake severely damaged USS's manufacturing plant. Because the difference between the projected profits and actual profits was due to an extraordinary event that was beyond the control of USS, and could not reasonably have been anticipated at the time the license was entered into, the requirement under § 1.482-4(f)(2)(ii)(D) has been met, and no adjustment under this section is made.

(3) *Ownership of intangible property—*
(i) *Identification of owner—*(A) *In general.* The legal owner of intangible property pursuant to the intellectual

property law of the relevant jurisdiction, or the holder of rights constituting an intangible property pursuant to contractual terms (such as the terms of a license) or other legal provision, will be considered the sole owner of the respective intangible property for purposes of this section unless such ownership is inconsistent with the economic substance of the underlying transactions. See § 1.482-1(d)(3)(ii)(B) (identifying contractual terms). If no owner of the respective intangible property is identified under the intellectual property law of the relevant jurisdiction, or pursuant to contractual terms (including terms imputed pursuant to § 1.482-1(d)(3)(ii)(B)) or other legal provision, then the controlled taxpayer who has control of the intangible property, based on all the facts and circumstances, will be considered the sole owner of the intangible property for purposes of this section.

(B) *Cost sharing arrangements.* The rules in this paragraph (f)(3) regarding ownership with respect to cost shared intangibles and cost sharing arrangements will apply only as provided in § 1.482-7.

(ii) *Examples.* The principles of this paragraph (f)(3) are illustrated by the following examples:

Example 1. FP, a foreign corporation, is the registered holder of the AA trademark in the United States. FP licenses to its U.S. subsidiary, USSub, the exclusive rights to manufacture and market products in the United States under the AA trademark. FP is the owner of the trademark pursuant to intellectual property law. USSub is the owner of the license pursuant to the terms of the license, but is not the owner of the trademark. See paragraphs (b)(3) and (4) of this section (defining an intangible as, among other things, a trademark or a license).

Example 2. The facts are the same as in *Example 1*. As a result of its sales and marketing activities, USSub develops a list of several hundred creditworthy customers that regularly purchase AA trademarked products. Neither the terms of the contract between FP and USSub nor the relevant intellectual property law specify which party owns the customer list. Because USSub has knowledge of the contents of the list, and has practical control over its use and dissemination, USSub is considered the sole owner of the customer list for purposes of this paragraph (f)(3).

(4) *Contribution to the value of intangible property owned by another*—(i) *In general.* The arm's length consideration for a contribution by one controlled taxpayer that develops or enhances the value, or may be reasonably anticipated to develop or enhance the value, of intangible property owned by another controlled taxpayer will be determined in accordance with the applicable rules under section 482. If the consideration for such a contribution is embedded within the contractual terms for a controlled transaction that involves such intangible property, then ordinarily no separate allocation will be made with respect to such contribution. In such cases, pursuant to § 1.482-1(d)(3), the contribution must be accounted for in evaluating the comparability of the controlled transaction to uncontrolled comparables, and accordingly in determining the arm's length consideration in the controlled transaction.

(ii) *Examples.* The principles of this paragraph (f)(4) are illustrated by the following examples:

Example 1. A, a member of a controlled group, allows B, another member of the controlled group, to use tangible property, such as laboratory equipment, in connection with B's development of an intangible that B owns. By furnishing tangible property, A makes a contribution to the development of intangible property owned by another controlled taxpayer, B. Pursuant to paragraph (f)(4)(i) of this section, the arm's length charge for A's furnishing of tangible property will be determined under the rules for use of tangible property in § 1.482-2(c).

Example 2. (i) *Facts.* FP, a foreign producer of wristwatches, is the registered holder of the YY trademark in the United States and in other countries worldwide. FP enters into an exclusive, five-year, renewable agreement with its newly organized U.S. subsidiary, USSub. The contractual terms of the agreement grant USSub the exclusive right to re-sell YY trademark wristwatches in the United States, obligate USSub to pay a fixed price per wristwatch throughout the entire term of the contract, and obligate both FP and USSub to undertake without separate compensation specified types and levels of marketing activities.

(ii) The consideration for FP's and USSub's marketing activities, as well as the consideration for the exclusive right to re-sell YY trademarked merchandise in the United States, are embedded in the transfer price paid for the wristwatches. Accordingly, pursuant to paragraph (f)(4)(i) of this section,

ordinarily no separate allocation would be appropriate with respect to these embedded contributions.

(iii) Whether an allocation is warranted with respect to the transfer price for the wristwatches is determined under §§ 1.482-1, 1.482-3, and this section through § 1.482-6. The comparability analysis would include consideration of all relevant factors, including the nature of the intangible property embedded in the wristwatches and the nature of the marketing activities required under the agreement. This analysis would also take into account that the compensation for the activities performed by USSub and FP, as well as the consideration for USSub's use of the YY trademark, is embedded in the transfer price for the wristwatches, rather than provided for in separate agreements. See §§ 1.482-3(f) and 1.482-9(m)(4).

Example 3. (i) *Facts.* FP, a foreign producer of athletic gear, is the registered holder of the AA trademark in the United States and in other countries. In year 1, FP licenses to a newly organized U.S. subsidiary, USSub, the exclusive rights to use certain manufacturing and marketing intangible property to manufacture and market athletic gear in the United States under the AA trademark. The license agreement obligates USSub to pay a royalty based on sales of trademarked merchandise. The license agreement also obligates FP and USSub to perform without separate compensation specified types and levels of marketing activities. In year 1, USSub manufactures and sells athletic gear under the AA trademark in the United States.

(ii) The consideration for FP's and USSub's respective marketing activities is embedded in the contractual terms of the license for the AA trademark. Accordingly, pursuant to paragraph (f)(4)(i) of this section, ordinarily no separate allocation would be appropriate with respect to the embedded contributions in year 1. See § 1.482-9(m)(4).

(iii) Whether an allocation is warranted with respect to the royalty under the license agreement would be analyzed under § 1.482-1, and this section through § 1.482-6. The comparability analysis would include consideration of all relevant factors, such as the term and geographical exclusivity of the license, the nature of the intangible property subject to the license, and the nature of the marketing activities required to be undertaken pursuant to the license. Pursuant to paragraph (f)(4)(i) of this section, the analysis would also take into account the fact that the compensation for the marketing services is embedded in the royalty paid for use of the AA trademark, rather than provided for in a separate services agreement. For illustrations of application of the best method rule, see § 1.482-8 *Examples 10, 11, and 12.*

Example 4. (i) *Facts.* The year 1 facts are the same as in *Example 3*, with the following

exceptions. In year 2, USSub undertakes certain incremental marketing activities in addition to those required by the contractual terms of the license for the AA trademark executed in year 1. The parties do not execute a separate agreement with respect to these incremental marketing activities performed by USSub. The license agreement executed in year 1 is of sufficient duration that it is reasonable to anticipate that USSub will obtain the benefit of its incremental activities, in the form of increased sales or revenues of trademarked products in the U.S. market.

(ii) To the extent that it was reasonable to anticipate that USSub's incremental marketing activities would increase the value only of USSub's intangible property (that is, USSub's license to use the AA trademark for a specified term), and not the value of the AA trademark owned by FP, USSub's incremental activities do not constitute a contribution for which an allocation is warranted under paragraph (f)(4)(i) of this section.

Example 5. (i) *Facts.* The year 1 facts are the same as in *Example 3*. In year 2, FP and USSub enter into a separate services agreement that obligates USSub to perform certain incremental marketing activities to promote AA trademark athletic gear in the United States, above and beyond the activities specified in the license agreement executed in year 1. In year 2, USSub begins to perform these incremental activities, pursuant to the separate services agreement with FP.

(ii) Whether an allocation is warranted with respect to USSub's incremental marketing activities covered by the separate services agreement would be evaluated under §§1.482-1 and 1.482-9, including a comparison of the compensation provided for the services with the results obtained under a method pursuant to §1.482-9, selected and applied in accordance with the best method rule of §1.482-1(c).

(iii) Whether an allocation is warranted with respect to the royalty under the license agreement is determined under §1.482-1, and this section through §1.482-6. The comparability analysis would include consideration of all relevant factors, such as the term and geographical exclusivity of the license, the nature of the intangible property subject to the license, and the nature of the marketing activities required to be undertaken pursuant to the license. The comparability analysis would take into account that the compensation for the incremental activities by USSub is provided for in the separate services agreement, rather than embedded in the royalty paid for use of the AA trademark. For illustrations of application of the best method rule, see §1.482-8 *Examples 10, 11, and 12*.

Example 6. (i) *Facts.* The year 1 facts are the same as in *Example 3*. In year 2, FP and USSub enter into a separate services agreement that obligates FP to perform incremental marketing activities, not specified in the year 1 license, by advertising AA trademarked athletic gear in selected international sporting events, such as the Olympics and the soccer World Cup. FP's corporate advertising department develops and coordinates these special promotions. The separate services agreement obligates USSub to pay an amount to FP for the benefit to USSub that may reasonably be anticipated as the result of FP's incremental activities. The separate services agreement is not a qualified cost sharing arrangement under §1.482-7T. FP begins to perform the incremental activities in year 2 pursuant to the separate services agreement.

(ii) Whether an allocation is warranted with respect to the incremental marketing activities performed by FP under the separate services agreement would be evaluated under §1.482-9. Under the circumstances, it is reasonable to anticipate that FP's activities would increase the value of USSub's license as well as the value of FP's trademark. Accordingly, the incremental activities by FP may constitute in part a controlled services transaction for which USSub must compensate FP. The analysis of whether an allocation is warranted would include a comparison of the compensation provided for the services with the results obtained under a method pursuant to §1.482-9, selected and applied in accordance with the best method rule of §1.482-1(c).

(iii) Whether an allocation is appropriate with respect to the royalty under the license agreement would be evaluated under §§1.482-1 through 1.482-3, this section, and §§1.482-5 and 1.482-6. The comparability analysis would include consideration of all relevant factors, such as the term and geographical exclusivity of USSub's license, the nature of the intangible property subject to the license, and the marketing activities required to be undertaken by both FP and USSub pursuant to the license. This comparability analysis would take into account that the compensation for the incremental activities performed by FP was provided for in the separate services agreement, rather than embedded in the royalty paid for use of the AA trademark. For illustrations of application of the best method rule, see §1.482-8, *Example 10, Example 11, and Example 12*.

(5) *Consideration not artificially limited.* The arm's length consideration for the controlled transfer of an intangible is not limited by the consideration paid in any uncontrolled transactions that do not meet the requirements of the comparable uncontrolled transaction method described in paragraph (c) of

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this section. Similarly, the arm's length consideration for an intangible is not limited by the prevailing rates of consideration paid for the use or transfer of intangibles within the same or similar industry.

(6) *Lump sum payments*—(i) *In general.* If an intangible is transferred in a controlled transaction for a lump sum, that amount must be commensurate with the income attributable to the intangible. A lump sum is commensurate with income in a taxable year if the equivalent royalty amount for that taxable year is equal to an arm's length royalty. The equivalent royalty amount for a taxable year is the amount determined by treating the lump sum as an advance payment of a stream of royalties over the useful life of the intangible (or the period covered by an agreement, if shorter), taking into account the projected sales of the licensee as of the date of the transfer. Thus, determining the equivalent royalty amount requires a present value calculation based on the lump sum, an appropriate discount rate, and the projected sales over the relevant period. The equivalent royalty amount is subject to periodic adjustments under § 1.482-4(f)(2)(i) to the same extent as an actual royalty payment pursuant to a license agreement.

(ii) *Exceptions.* No periodic adjustment will be made under paragraph (f)(2)(i) of this section if any of the exceptions to periodic adjustments provided in paragraph (f)(2)(ii) of this section apply.

(iii) *Example.* The following example illustrates the principle of this paragraph (f)(5).

Example. Calculation of the equivalent royalty amount. (i) FSub is the foreign subsidiary of USP, a U.S. company. USP licenses FSub the right to produce and sell the whopperchopper, a patented new kitchen appliance, for the foreign market. The license is for a period of five years, and payment takes the form of a single lump-sum charge of \$500,000 that is paid at the beginning of the period.

(ii) The equivalent royalty amount for this license is determined by deriving an equivalent royalty rate equal to the lump-sum payment divided by the present discounted value of FSub's projected sales of whopperchoppers over the life of the license. Based on the riskiness of the whopperchopper business, an appropriate discount rate is determined to be

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10 percent. Projected sales of whopperchoppers for each year of the license are as follows:

| Year | Projected sales |
|---------|-----------------|
| 1 | \$2,500,000 |
| 2 | 2,600,000 |
| 3 | 2,700,000 |
| 4 | 2,700,000 |
| 5 | 2,750,000 |

(iii) Based on this information, the present discounted value of the projected whopperchopper sales is approximately \$10 million, yielding an equivalent royalty rate of approximately 5%. Thus, the equivalent royalty amounts for each year are as follows:

| Year | Projected sales | Equivalent royalty amount |
|---------|-----------------|---------------------------|
| 1 | \$2,500,000 | \$125,000 |
| 2 | 2,600,000 | 130,000 |
| 3 | 2,700,000 | 135,000 |
| 4 | 2,700,000 | 135,000 |
| 5 | 2,750,000 | 137,500 |

(iv) If in any of the five taxable years the equivalent royalty amount is determined not to be an arm's length amount, a periodic adjustment may be made pursuant to § 1.482-4(f)(2)(i). The adjustment in such case would be equal to the difference between the equivalent royalty amount and the arm's length royalty in that taxable year.

(g) *Coordination with rules governing cost sharing arrangements.* Section 1.482-7 provides the specific methods to be used to determine arm's length results of controlled transactions in connection with a cost sharing arrangement. This section provides the specific methods to be used to determine arm's length results of a transfer of intangible property, including in an arrangement for sharing the costs and risks of developing intangibles other than a cost sharing arrangement covered by § 1.482-7. In the case of such an arrangement, consideration of the principles, methods, comparability, and reliability considerations set forth in § 1.482-7 is relevant in determining the best method, including an unspecified method, under this section, as appropriately adjusted in light of the differences in the facts and circumstances between such arrangement and a cost sharing arrangement.

(h) *Effective/applicability date*—(1) *In general.* Except as provided in the succeeding sentence, the provisions of paragraphs (f)(3) and (4) of this section are generally applicable for taxable

years beginning after December 31, 2006. The provisions of paragraphs (f)(3)(i)(B) and (g) of this section are generally applicable on January 5, 2009.

(2) *Election to apply regulation to earlier taxable years.* A person may elect to apply the provisions of paragraphs (f)(3) and (4) of this section to earlier taxable years in accordance with the rules set forth in § 1.482-9(n)(2).

[T.D. 8552, 59 FR 35016, July 8, 1994; T.D. 9278, 71 FR 44484, Aug. 4, 2006; T.D. 9456, 74 FR 38842, Aug. 4, 2009; T.D. 9568, 76 FR 80090, Dec. 22, 2011]

§ 1.482-5 Comparable profits method.

(a) *In general.* The comparable profits method evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances.

(b) *Determination of arm's length result—(1) In general.* Under the comparable profits method, the determination of an arm's length result is based on the amount of operating profit that the tested party would have earned on related party transactions if its profit level indicator were equal to that of an uncontrolled comparable (comparable operating profit). Comparable operating profit is calculated by determining a profit level indicator for an uncontrolled comparable, and applying the profit level indicator to the financial data related to the tested party's most narrowly identifiable business activity for which data incorporating the controlled transaction is available (relevant business activity). To the extent possible, profit level indicators should be applied solely to the tested party's financial data that is related to controlled transactions. The tested party's reported operating profit is compared to the comparable operating profits derived from the profit level indicators of uncontrolled comparables to determine whether the reported operating profit represents an arm's length result.

(2) *Tested party—(i) In general.* For purposes of this section, the tested party will be the participant in the controlled transaction whose operating profit attributable to the controlled transactions can be verified using the

most reliable data and requiring the fewest and most reliable adjustments, and for which reliable data regarding uncontrolled comparables can be located. Consequently, in most cases the tested party will be the least complex of the controlled taxpayers and will not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables.

(ii) *Adjustments for tested party.* The tested party's operating profit must first be adjusted to reflect all other allocations under section 482, other than adjustments pursuant to this section.

(3) *Arm's length range.* See § 1.482-1(e)(2) for the determination of the arm's length range. For purposes of the comparable profits method, the arm's length range will be established using comparable operating profits derived from a single profit level indicator.

(4) *Profit level indicators.* Profit level indicators are ratios that measure relationships between profits and costs incurred or resources employed. A variety of profit level indicators can be calculated in any given case. Whether use of a particular profit level indicator is appropriate depends upon a number of factors, including the nature of the activities of the tested party, the reliability of the available data with respect to uncontrolled comparables, and the extent to which the profit level indicator is likely to produce a reliable measure of the income that the tested party would have earned had it dealt with controlled taxpayers at arm's length, taking into account all of the facts and circumstances. The profit level indicators should be derived from a sufficient number of years of data to reasonably measure returns that accrue to uncontrolled comparables. Generally, such a period should encompass at least the taxable year under review and the preceding two taxable years. This analysis must be applied in accordance with § 1.482-1(f)(2)(iii)(D). Profit level indicators that may provide a reliable basis for comparing operating profits of the tested party and uncontrolled comparables include the following—

(i) *Rate of return on capital employed.* The rate of return on capital employed